

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PIT:TL-7037-99
FAFalvo

date:

to: L. Jerry Fisher, Case Manager

from: Associate District Counsel, Pennsylvania District, Pittsburgh

subject: [REDACTED]

This is in response to your request for advice regarding the above-named taxpayer.

ISSUE

Whether the salaries paid to various employees of companies acquired by the taxpayer constitute capitalized costs subject to amortization under I.R.C. § 197.

CONCLUSION

The salaries are not capitalized costs subject to amortization under section 197.

FACTS

All of the facts set forth herein have been provided by the Examination Division.

The taxpayer, [REDACTED], acquired three companies during [REDACTED] and [REDACTED]. The acquisitions were consummated either by exchanging stock of [REDACTED] for the stock of the acquired companies or by purchasing the stock for cash. According to the revenue agent, the acquisitions were as follows.

On [REDACTED], [REDACTED] shares of stock of [REDACTED] were acquired by [REDACTED], a subsidiary of [REDACTED], for \$ [REDACTED]. The purchase price was paid by the issuance of [REDACTED] stock to the sellers. [REDACTED] entered into employment contracts with two key employees on [REDACTED]. The annual salary was \$ [REDACTED] for one employee and \$ [REDACTED] for the other employee.

A stock purchase agreement was executed in [REDACTED] between [REDACTED] and [REDACTED]. A stock exchange agreement dated [REDACTED] was executed among [REDACTED] and all the shareholders of [REDACTED]. The agreement provided that [REDACTED] shares of [REDACTED] stock valued at \$ [REDACTED] were exchanged for [REDACTED] shares of [REDACTED] stock.

At the time of the acquisition, [REDACTED] had a [REDACTED] year employment contract with its president, which commenced in [REDACTED] and provided for an annual salary of \$ [REDACTED]. The stock purchase agreement required [REDACTED] to enter into employment contracts with certain specified employees. [REDACTED] year employment contracts became effective in [REDACTED] for [REDACTED] employees. These [REDACTED] employees received salaries ranging from \$ [REDACTED] to \$ [REDACTED] per year.

[REDACTED] entered into a stock acquisition agreement dated [REDACTED] with [REDACTED]. [REDACTED] paid cash of \$ [REDACTED] for [REDACTED] shares of [REDACTED]. Employment agreements were entered into at the same time between [REDACTED] and [REDACTED] employees of [REDACTED]. The [REDACTED] most highly compensated employees were paid salaries ranging from \$ [REDACTED] to \$ [REDACTED] per year. In addition, [REDACTED] of these employees were paid bonuses totaling \$ [REDACTED] to be paid in [REDACTED] months. Other employees received bonuses totaling \$ [REDACTED].

Prior to the acquisition of [REDACTED], [REDACTED] conducted an evaluation of [REDACTED]'s value. The evaluation stated that the book value of [REDACTED] was approximately \$ [REDACTED] and that [REDACTED] "has never really made any money." The evaluation concluded that "because of the fact that we are essentially buying the people, the deal structure should include an incentive for key management and key employees to remain for at least three years."

We are advised by the revenue agent that the salaries paid to the various employees of the three acquired companies pursuant to the employment contracts do not appear to be unreasonable. The respective companies each deducted the salaries in the years paid.

The prior case coordinator assigned to the examination of the taxpayer for the years at issue considered the employment contracts as intangible assets acquired either through the acquisition of a trade or business or created by the taxpayer in connection with the acquisition of a trade or business. The prior coordinator recommended disallowance of all deductions claimed in [REDACTED] and [REDACTED] with respect to the salaries and wages

paid to the key employees who had entered into employment contracts. Instead, the coordinator recommended that all wages and salaries paid to these employees be capitalized and amortized over a period of 15 years, pursuant to I.R.C. § 197.

DISCUSSION

I.R.C. § 197 allows taxpayers an amortization deduction for the capitalized costs of acquiring "section 197 intangibles" that are held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. No other deduction for depreciation or amortization is allowed for an acquired section 197 intangible. I.R.C. § 197(b). Section 197 intangibles are defined in section 197(d) to include, among other items, workforce in place.

The amount of the amortization deduction with respect to any "amortizable section 197 intangible" is determined by amortizing the adjusted basis of the intangible over a 15-year period. Prop. Reg. § 1.197-2(f)(1)(ii) states that, except as otherwise provided, the adjusted basis is determined under I.R.C. § 1011.

Section 197 only applies to direct acquisitions of § 197 intangibles and not to the indirect acquisition of the intangibles through an acquisition of stock. Section 197(e)(1)(A). However, if the buyer makes an election under § 338 to treat the acquisition of stock as an asset acquisition, section 197 will apply to the acquired intangibles.

The Preamble to Prop. Reg. § 1.197-2 provides that because section 197 provides a method of amortization and does not alter the rules for determining the basis of an asset, section 197 generally does not apply to amounts that would otherwise be deductible. For example, section 197 generally does not apply to the costs of advertising because, in most cases, these costs are deductible under other provisions of the Code. See Rev. Rul. 92-80 (1992-2 C.B. 57). The preamble further states that section 197 does not apply to costs that would not, under general principals of Federal income tax law, be included in the basis of a section 197 intangible. For example, if a taxpayer borrows money to purchase the assets of a trade or business (including amortizable section 197 intangibles) and incurs fees in connection with the loan, these costs are generally amortized over the term of the loan rather than under the rules of sections 167(f) and 197. As a further example, the preamble provides that if the amortizable section 197 intangibles acquired in a transaction include a favorable supply contract, the amortizable basis in the contract does not include amounts required to be paid for goods to be received pursuant to the

contract. Preamble to Prop. Reg. § 1.197-2, January 16, 1997.

In determining whether section 197 applies to the employment contracts in this case, it must initially be determined whether these employment contracts constituted the acquisition of an intangible asset. The prior revenue agent has taken the position that the salary and wages paid to the employees pursuant to the various employment contracts must be capitalized and amortized because the contracts were intangible assets. However, no evidence has been presented to show that any portion of the purchase prices paid by [REDACTED] to acquire the three businesses represented payment for the purchase of the employment contracts. If no portion of the purchase price was paid for the value of the employment contracts, we are unable to ascertain how the employment contracts could be amortized.

The revenue agent currently assigned to this examination asserts that the salary and wages paid to the various employees pursuant to the employment contracts are not unreasonable and appear to represent fair compensation for the services rendered. In order to capitalize and amortize an expense under section 197, it must initially be established that the taxpayer acquired an intangible asset. The payment of salary and wages to employees does not necessarily constitute the acquisition of the employment contracts. Based upon the current revenue agent's assertion, the wages and salary payments appear to be ordinary and necessary business expenses deductible in the year in which they are paid. Section 197 does not affect the treatment of expenses for compensation under section 162(a) of the Code. If the expenses are otherwise deductible under applicable principles of the federal tax law, section 197 does not make those costs nondeductible.

I.R.C. § 162 provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for services actually rendered. Section 1.162-7(a) of the Income Tax Regulations provides, in part, that the test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Section 1.162-7(b) of the regulations provides clarifying guidelines for the application of paragraph (a). Paragraph (b)(1) states that any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. Examples of this principle cited in the paragraph include payments of dividends or payments for property that are disguised as salary. In neither case would the payment be

deductible. Paragraph (b)(2) provides that the form or method of fixing compensation is not decisive as to deductibility. It further states that generally, if compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing fair and advantageous terms for the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

Paragraph (b)(3) states that in any event the allowance for the compensation may not exceed what is reasonable under all circumstances. Paragraph (b)(3) further states that it is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to take into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

According to the foregoing provisions, expenses incurred for wages, salary and other forms of compensation are deductible as ordinary and necessary business expenses so long as they are both reasonable and paid solely for personal services rendered to that business.

No evidence has been presented to indicate that the amounts paid for salaries and wages represent something other than reasonable compensation for personal services rendered. To the contrary, it appears that the payments made pursuant to the employment contracts were for the personal services performed during the year paid. This is confirmed by the current case coordinator, who states that the compensation is not unreasonable.

Even if compensation is reasonable in amount and is paid solely for personal services rendered, the expenditure may still be nondeductible if it pertains to services which are not rendered in the ordinary course of the taxpayer's trade or business or if it is otherwise capital in nature. Courts have consistently held that costs incurred as an incident to a corporate reorganization, recapitalization or acquisition by another entity should be capitalized. Indopco, Inc. v. Commissioner, 112 S.Ct. 1039 (1992).

Although the rationale for the prior revenue agent's disallowance of the compensation expenses is somewhat vague, it appears that the agent believes the expenditures must be

capitalized because they originated from the acquisition of an intangible asset, the "know-how" of these employees. We do not believe this characterization is correct. In our view, the payment of the wages to the contracted employees has its origin in the employment relationship between the employees and the respective employers and not in the acquisition of the stock by Equitable Resources.

If it can be shown that the expenditures at issue are not reasonable or represent payment for some other purpose, such as a disguised payment to acquire the stock of the three purchased companies, then the Service could attempt to allocate all or a portion of the payment to the cost of acquiring the employment contracts. However, in light of the facts presented at this time, it would be incumbent upon the Examination Division to develop sufficient evidence to establish that the payment of wages and salaries pursuant to the employment contracts were not reasonable or represent payment for something other than compensation. If sufficient facts are developed, we would consider whether the costs of acquiring the employment contracts are amortizable section 197 intangibles. Otherwise, it remains our opinion that the compensation paid to the various employees pursuant to employment contracts are ordinary and necessary business expenses currently deductible under I.R.C. § 162.

If you have any questions in this matter, please contact Frank A. Falvo at 644-3417.

EDWARD F. PEDUZZI, JR.
Associate District Counsel